

# HAVE DISPARITIES IN STATE TAX TREATMENT OF SINGLE MEMBER LIMITED LIABILITY COMPANIES CREATED A TAX OVERLAP FOR INTERSTATE BUSINESSES?

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*For entrepreneurs looking to expand their business to other states, a limited liability company ("LLC") structure appears to be the entity of choice. In particular, single-member LLCs ("SMLLC") may be attractive for an entrepreneur seeking interstate expansion because they are less complicated than the traditional use of a consolidated group consisting of a corporate parent and subsidiary corporations and are treated as disregarded entities for federal income tax purposes.*

*But lack of consistency within some state tax provisions has created uncertainty surrounding the treatment of SMLLCs for state tax purposes. Several states have updated their state tax regulations, broadening their tax base to hold SMLLCs subject to entity-level state taxation. In contrast, other states have adopted an approach that an ownership interest in a SMLLC may establish state tax nexus, and expose a non-resident entrepreneur single member to tax nexus within that state. Dissimilarity between these two state income tax approaches has created a potential tax overlap, subjecting unwary entrepreneurs who created SMLLC subsidiaries for tax benefits, to double taxation they had sought to avoid.*

For entrepreneurs looking to expand their business to other states, a limited liability company ("LLC") structure appears the entity of choice. A hybrid between corporation and partnership structures, the LLC provides a shield of limited liability to its members, while remaining liable to only a single level of taxation.<sup>1</sup> Additionally, LLCs are easier to form than corporations and many consider the LLC structure to be the most flexible business vehicle.<sup>2</sup>

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<sup>1</sup> Pomy Ketema, *Did the Federal Check-the-Box Regulations Open Up a State Tax Pandora's Box? A Reflection on State Conformity to the New Federal Classification Scheme of Single-Member LLCs*, 82 MINN. L. REV. 1659, 1660 (1998).

<sup>2</sup> See Bradley J. Sklar & W. Todd Carlisle, *The Alabama Limited Liability Act*, 45 ALA. L. REV. 145, 148, 157 (1993).

In particular, single-member LLCs (“SMLLC”)—those LLCs owned wholly by one individual or by another entity like a corporation—may be attractive for an entrepreneur seeking interstate expansion because they are less complicated than the traditional model, which consists of a corporate parent with subsidiary corporations. However, lack of consistency within some state tax provisions has created uncertainty surrounding the treatment of SMLLCs for state tax purposes. Several states have updated their state tax regulations, broadening their tax base and holding SMLLCs subject to entity-level state taxation, even though they are treated as disregarded entities for federal income tax purposes.<sup>3</sup> In contrast, other states have adopted an approach that an ownership interest in a SMLLC may establish state tax nexus, and expose a non-resident entrepreneur single member to tax nexus within that state. The dissimilarity between these two state income tax approaches has created a potential tax overlap, subjecting unwary entrepreneurs who created SMLLC subsidiaries for tax benefits, to double taxation after all.

A simple example will illustrate the potential double taxation. Abe owns two SMLLCs – one in State A (where Abe lives), the other in neighboring State B. If both State A and State B follow federal taxation rules and treat SMLLCs as disregarded entities, then Abe will be taxed on the incomes from the SMLLCs in both State A and State B. If, however, State A treats SMLLCs as disregarded entities but State B imposes an entity-level tax on SMLLCs, State B will tax the income of that SMLLC, while State A will still tax Abe’s income from both SMLLCs. Without an available tax credit for the tax paid in State B for the SMLLC, Abe will be taxed on two levels—once at the entity-level (State B’s SMLLC tax) and again for the income he earned through both SMLLCs.

This Note explores the state tax concerns of entrepreneurs looking to expand their businesses to other states as SMLLCs. Part I examines the historical development of the limited liability company in the United States and events that led to its popularity. Part II discusses the implications resulting from increased use of SMLLCs in interstate business expansion, in particular, its role in state tax revenue depletion. Part III highlights some states’ response to depleting tax revenue: broadening the tax base to include entity-level taxation of SMLLCs. Part IV examines the current Constitutional debate whether mere ownership interest in an in-state company exposes a non-resident owner to state income taxation within that state, and what this may mean for out-of-state owners of in-state SMLLCs. Part V illustrates how the unsettled state income tax nexus debate can add to the already divisive issue of how to treat SMLLCs for state tax purposes. Finally, Part VI highlights issues entrepreneurs should consider before establishing SMLLC subsidiaries in neighboring states.

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<sup>3</sup> Patrick Henry Smith, *Taxation by States of Single-Member Limited Liability Companies*, 9 WG&L 5, pg. 1 (Sept./Oct. 2007).

## I. HISTORY OF THE LLC AND ITS RISE TO POPULARITY

The notion of a limited liability company is relatively new to the United States. Over one hundred years ago, the German empire created an entity in which owners were not personally liable for the company's debts, which they called "gesellschaft mit beschränkter haftung"<sup>4</sup> ("GmbH"), literally translated to mean a "company with limited liability."<sup>5</sup> Since then, the limited liability structure spread throughout Europe and South America.<sup>6</sup> Similar entities were introduced "in Brazil in 1919, France in 1925, Cuba in 1929, Argentina in 1932, Mexico in 1934, Belgium in 1935, and Switzerland and Italy in 1936."<sup>7</sup> The limited liability company reached the United States in the early 1970s when a Wyoming oil company collaborated with Panamanian LLCs in oil and gas exploration.<sup>8</sup> The U.S. oil company, impressed with the LLC concept, proposed legislation in Wyoming to allow for a similar entity.<sup>9</sup> On May 16, 1977, following enactment by the Wyoming legislature in March of the same year, the oil company created the first LLC in the United States.<sup>10</sup>

Initially, American entrepreneurs were hesitant to adopt the new entity structure, because of uncertainty surrounding its tax status.<sup>11</sup> Florida became the second state to enact an LLC statute five years after Wyoming,<sup>12</sup> but it was not until 1988, when the IRS ruled that an LLC "would be treated as a partnership for federal income tax purposes, that the interest in LLCs exploded."<sup>13</sup> The 1988 IRS regulations stated that any income or loss to an LLC would "pass through" directly to the members of the company as allocable income in proportion to their ownership interest.<sup>14</sup> As a result, the IRS reassured businesses that LLCs would act as "pass-through entities" for federal income tax purposes, and not be subjected to

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<sup>4</sup> Ingrid Lynn Lenhardt, *Eighth Annual Corporate Law Symposium: Limited Liability Companies: The Corporate and Tax Advantages of a Limited Liability Company: A German Perspective*, 64 U. CIN. L. REV. 551, 551 (1996).

<sup>5</sup> Company Extensions and Security Identifiers, Corporate Information, available at <http://www.corporateinformation.com/Company-Extensions-Security-Identifiers.aspx> (last visited Sept. 22, 2008).

<sup>6</sup> Garry A. Pearson, *The North Dakota Limited Liability Company Act: Formation and Tax Consequences*, 70 N.D. L. REV. 67, 70 (1994).

<sup>7</sup> *Id.*

<sup>8</sup> Letter from A.J. Miller, Executive Vice President, Hamilton Brothers Oil Company to Walter Urbigkit, Chief Justice of Wyoming Supreme Court. (June 5, 1992).

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> Rebecca J. Huss, *Revamping Veil Piercing for all Limited Liability Entities: Forcing the Common Law Doctrine into the Statutory Age*, 70 U. CIN. L. REV. 95, 97 (2001).

<sup>12</sup> Jimmy G. McLaughlin, *The Limited Liability Company: A Prime Choice for Professionals*, 45 ALA. L. REV. 231, 231 (1993).

<sup>13</sup> *Id.*

<sup>14</sup> See *Id.* at 232, 248

two-level income taxation like standard corporations.<sup>15</sup> Rather, LLCs would be subject to single-level taxation, similar to partnerships and S corporations.<sup>16</sup> And without the restrictive rules imposed on S corporations,<sup>17</sup> LLCs provide owners the same liability insulation from the company's obligations as afforded to corporations.<sup>18</sup>

Furthermore, with the creation of IRS "check-the-box" regulations in 1996, entrepreneurs developed a new-found interest in creating SMLLCs as an alternative to the corporate parent-subsidary structure. Under the "check-the-box" rules, "unless a SMLLC chooses to be taxed as a corporation, it will be disregarded for federal income tax purposes"<sup>19</sup> and, similar to a sole proprietorship, all income gains or losses are treated as the gains and losses of the owner.<sup>20</sup> Therefore, because "all the activities of an entity [a disregarded entity] are treated as if they were actually performed by the owner,"<sup>21</sup> the owner of a SMLLC no longer needed to file consolidated returns like corporate parent-subsidaries.<sup>22</sup> Instead, the IRS "check-the-box" regulations allowed a SMLLC owner to report the income gain, loss or deduction on his or her own "tax return as if the business were operated as a sole proprietorship."<sup>23</sup> In other words, the "check-the-box" rules allowed businesses to use SMLLCs instead of corporate subsidiaries to isolate the tax liabilities of one subsidiary from another, while permitting the combination of all business income of each SMLLC for tax reporting purposes.<sup>24</sup>

Since the "check-the-box" rules in 1996, in order to meet entrepreneurial demand to expand business with LLCs instead of the traditional corporate parent-subsidary structure, states have amended their LLC statutes to allow not only for multi-member LLCs, but SMLLCs as well. In 1998, thirty-one states had updated their legislation to allow the

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<sup>15</sup> *Id.* at 232, 247.

<sup>16</sup> *Id.* at 248.

<sup>17</sup> Sklar & Carlisle, *supra* note 2, at 148. "The complexities involved in qualifying for and maintaining S corporation status remain a virtual minefield for corporate and tax practitioners." *Id.*; See also I.R.C. §1361(b) (2008). In order to qualify and maintain an S Corporation, the company may not expand to obtain more than 100 shareholders and the company may not issue more than one class of stock. *Id.* Additionally, financial institutions, insurance companies and foreign corporations are ineligible to acquire S corporation status. *Id.*

<sup>18</sup> McLaughlin, *supra* note 12, at 241.

<sup>19</sup> Ketema, *supra* note 1, at 1669.

<sup>20</sup> *Id.*

<sup>21</sup> Christopher Barton, *Much Ado About a Nothing: The Taxation of Disregarded Entities*, 75 TAX NOTES 1883, 1883 (1997).

<sup>22</sup> Ketema, *supra* note 1, at 1669-1670. Corporate parent-subsidaries require filing a consolidated return, which is governed by very complex consolidated return regulations. *Id.*

<sup>23</sup> *Id.* at 1669.

<sup>24</sup> *Id.* at 1682.

formation of SMLLCs.<sup>25</sup> By 2001, forty-nine states had amended their LLC statutes to accommodate SMLLCs.<sup>26</sup> Today, all fifty states have enacted legislation permitting SMLLCs within their jurisdictions.<sup>27</sup>

## II. DEPLETING STATE TAX REVENUES AND A NEED FOR STATE TAX REFORM

While SMLLC popularity skyrocketed, many theorists debated whether the new entity would lead to state tax revenue depletion.<sup>28</sup> Some worried that if more businesses registered as LLCs rather than corporations, they would circumvent the corporate level income tax and ultimately reduce tax revenue.<sup>29</sup> Such a prediction appeared reasonable, because while states were not required to follow federal “check-the-box” regulations for state tax purposes, the majority of states initially did, treating LLCs as pass-through entities and SMLLCs as disregarded entities.<sup>30</sup> On the other hand, some were confident that state tax revenue would remain unaffected by LLC popularity, because the type of business likely to use the LLC form would have previously been more likely to file as a limited partnership than as a corporation, and therefore would not have been subject to corporate level income tax anyway.<sup>31</sup>

In fact, as the use of SMLLCs has steadily risen, state corporate income tax revenues have correspondingly fallen.<sup>32</sup> Such a decline in state

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<sup>25</sup> *Id.* at 1667.

<sup>26</sup> Bruce P. Ely, *Update on Taxation of LLCs, LLPs and Their Owners*, THE TAX ADVISER, June 2001, at 406. In 2001, Massachusetts was the only state to require an LLC to have at least two members. *Id.*

<sup>27</sup> Massachusetts Amends Its Limited Liability Company Laws, Making Use of LLCs More Attractive, Client Alert from Goodwin Procter, LLP (March 24, 2003), available at <http://goodwinprocter.com/~media/20D8C132A64D487FA913C6051A4F0C9C.ashx> (last visited Sept. 22, 2008). Massachusetts was the last state to adopt such legislation, in March 2003. *Id.*

<sup>28</sup> Marybeth Bosko, *The Best of Both Worlds: The Limited Liability Company*, 54 OHIO ST. L.J. 175, 195-196 (1993).

<sup>29</sup> *Id.*

<sup>30</sup> See Smith, *supra* note 3, at 1.

<sup>31</sup> Bosko, *supra* note 28, at 196.

<sup>32</sup> Daniel Wilson, *The Mystery of Fallen State Corporate Income Taxes*, FEDERAL RESERVE BANK OF SAN FRANCISCO, Dec. 8, 2006, available at <http://www.frbsf.org/publications/economics/letter/2006/el2006-35.html>. (last visited Sept. 22, 2008); See also Joel Friedman, *The Decline of Corporate Income Tax Revenues*, CENTER ON BUDGET AND POLICY PRIORITIES (2003), available at <http://www.cbpp.org/10-16-03tax.htm> (last visited June Sept. 22, 2008). “Some argue that the weakness in corporate income tax revenues is, in part, a reflection of the decline in the number of C corporations which peaked at 2.6 million in 1986.” *Id.* Additionally, some point to fluxes in the overall economy as a contributing factor to the decline of corporate income tax. *Id.*

corporate income tax revenues has not, however, necessarily resulted in depleted overall state tax revenues. Instead, the income generated by the SMLLC is passed through to the individual's personal income tax form. The uncertainty lies in whether the taxing state can maintain state tax nexus over the individual taxpayer if his or her only contact with the taxing state is an investment interest in the SMLLC.<sup>33</sup> A taxing state determined not to have nexus over that individual may potentially lose the ability to tax income that was passed through from the in-state SMLLC to the out-of-state taxpayer. Such a potential result led at least one theorist to conclude that a rise in the use of LLCs became "an unintended means of narrowing the [tax] base in many states," because states failed to modernize their tax statutes "to accommodate the new form of business entity."<sup>34</sup> As more businesses were structured as pass-through entities, states' ability to collect tax under older tax regulations deteriorated.

### III. ENTITY LEVEL TAXES: EXPANDING THE STATE TAX BASE

While states generally do not tax SMLLCs that are disregarded for federal income tax purposes, other states have attempted to address their drop in tax revenue by broadening their state tax base.<sup>35</sup> Several have broadened their tax base by imposing entity-level income tax on SMLLCs,<sup>36</sup> to assure the collection process results in taxes collected. After all, "the goal should be to collect tax before the money leaves the state, either by taxing the earner directly or by withholding."<sup>37</sup> These base-broadening entity-level taxes, which differ from state to state, can often catch taxpayers off guard.<sup>38</sup>

For example, both Texas and New Hampshire amended their tax statutes to include LLCs in the definition of entities subject to tax.<sup>39</sup> Additionally, Ohio and Kentucky<sup>40</sup> extended entity-level taxation statutes to

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<sup>33</sup> See discussion *infra* Part IV.

<sup>34</sup> William F. Fox, *The Ongoing Evolution of State Revenue Systems*, 88 MARQ. L. REV. 19, 31 (2004).

<sup>35</sup> See *Id.* at 43-44; see also Smith, *supra* note 3, at 5.

<sup>36</sup> Smith, *supra* note 3, at 1.

<sup>37</sup> Lee A. Sheppard, *Self-Inflicted Wounds: What Europe Can Teach the States*, TAX NOTES, July 26, 2004, at 349, 354.

<sup>38</sup> Smith, *supra* note 3, at 5.

<sup>39</sup> *Id.* at 2.

<sup>40</sup> Kentucky H.B. 1 – *Conformity with Federal Income Tax Definition of "Corporation", Introduction of Limited Liability Entity Tax, and Other Changes*, DELOITTE, available at [http://www.deloitte.com/dtt/cda/doc/content/us\\_tax\\_alert\\_ky\\_210806.pdf](http://www.deloitte.com/dtt/cda/doc/content/us_tax_alert_ky_210806.pdf). In 2005, Kentucky amended its corporation income tax statute definition of "corporation" to include pass-through entities. *Id.* Later in 2007, Kentucky repealed such an expansion of the corporation income tax, returned its definition of "corporation" to comply with the federal income tax definition, and instead introduced the Limited Liability Entity Tax. *Id.*; see also K.R.S. 141.0401(2)(a)

tax each in-state SMLLC based on the its gross receipts or profits.<sup>41</sup> Additionally, Tennessee holds single-member SMLLCs subject to entity level tax if the sole owner is not a corporation.<sup>42</sup> By doing so, Tennessee “negated many of the pass-through characteristics that made them attractive business structures.”<sup>43</sup> Massachusetts has taken another approach, and taxes SMLLCs as an S corporation if the sole owner of the SMLLC is an S corporation.<sup>44</sup> Alabama has adopted an alternative approach, applying a “business privilege tax” evenhandedly to most limited liability entities.<sup>45</sup>

While some states have yet to amend their tax statutes, at least one theorist has argued that “the continuing diminution of the federal base should give state governments pause about whether they want to hitch their wagons to congressional whimsy.”<sup>46</sup> After all, “state corporate income taxes are a small and shrinking part of state revenues.”<sup>47</sup> Ultimately, although broadening its tax base may benefit the state, entrepreneurs must be fully aware of differing entity-level taxes that apply to single-member LLCs in the various states in which they do business.

#### IV. STATE TAX NEXUS: A STATE’S ANSWER, AN ENTREPRENEUR’S WORRY

A state cannot tax a non-resident individual or business unless the intended taxpayer has “nexus” with the state – meaning some link or minimum connection between the state and the person or business it seeks to tax.<sup>48</sup> That is *not* to say that states cannot hold in-state SMLLCs liable for taxes. As previously discussed, states have exercised their authority by establishing broader entity-level taxes that withhold tax from SMLLCs. “Income earned by an LLC owned by a single out-of-state member can be taxable under a state’s corporate income tax.”<sup>49</sup>

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added by H.B. 1. The initial expansion of Kentucky’s corporation income tax to include LLCs and SMLLCs differed from Ohio’s income tax regulations, thereby creating a tax overlap for an Ohio resident who owned a SMLLC in Kentucky. *See* discussion *infra* Part V. Kentucky has since remedied this tax overlap by returning to a federal income tax definition of “corporation” and creating a separate entity tax on limited liability entities.

<sup>41</sup> Smith, *supra* note 3, at 4.

<sup>42</sup> *Id.* at 3.

<sup>43</sup> T.J. Gentle, *Tennessee Tax Reform: How Does the F & E Tax Affect Your Business?*, Clayton Ctr. for Entrepreneurial Law, U. Tenn. College of Law, 1 Transactions 23, 25 (2000).

<sup>44</sup> Smith, *supra* note 3, at 3.

<sup>45</sup> Ely, *supra* note 26, at 406.

<sup>46</sup> Sheppard, *supra* note 37, at 355.

<sup>47</sup> *Id.* at 355.

<sup>48</sup> Deborah Rood & Karen Nakamura, *State Tax Implications of Employing Telecommunications*, THE TAX ADVISER, June 2005 at 361.

<sup>49</sup> Fox, *supra* note 34, at 31.

In fact, states may also tax other income generated from their state. States traditionally “have the authority to withhold tax on sales of in-state property, including intangibles, and on dividends paid by resident [S] corporations to nonresident shareholders.”<sup>50</sup> Additionally, under a partnership, because a partner is deemed to be in the business of his partnership, a state can tax out-of-state partners on their income derived from an in-state partnership. As a result, a partner is considered a taxpayer in every state where their partnership does business.<sup>51</sup> That is settled law.

Despite this seemingly broad authority, states’ taxation powers remain limited. While the Supreme Court has held that a state possesses jurisdiction over income generated within its boundaries, the Court has yet to explicitly conclude that a state may exercise jurisdiction over the *recipient* of the income<sup>52</sup> if that recipient is a nonresident owner of a SMLLC. Regardless, some states have recently concluded that a mere ownership interest in an LLC doing business in a state is sufficient to allow that state to assert taxing jurisdiction over that non-resident owner, whether an individual or business.<sup>53</sup> For example, in 2001 Georgia proposed regulations to deem that nonresident LLC partners or members (whether individuals or corporate entities) have nexus with that Georgia for income tax purposes “merely because of its status as a partner or member.”<sup>54</sup> Similarly, in 2001, New Jersey’s governor signed a bill that subjects companies without any other New Jersey nexus to income tax “by virtue of an ownership interest in...LLCs doing business in New Jersey.”<sup>55</sup> In essence, these states are imposing a state tax nexus on individuals and companies that operate outside of the state but possess an ownership interest in an LLC within.<sup>56</sup>

One theory to justify such authority is because many states do not treat LLCs as taxable entities in their own right, “the assertion of nexus over an LLC’s members may provide the only mechanism for a state to tax an LLC’s income.”<sup>57</sup> Furthermore, with regards to SMLLCs in particular, states seem justified in taxing sole owners (resident and non-resident) if the

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<sup>50</sup> Sheppard, *supra* note 37, at 354.

<sup>51</sup> Elizabeth Kolbert, *Nearly 10% of Law Partners Fail to File New York Taxes*, N.Y. TIMES, March 23, 1989, available at <http://query.nytimes.com/gst/fullpage.html?res=950DE2D81438F930A15750C0A96F948260&sec=&spon=&pagewanted=2>. (last visited Sept. 22, 2008).

<sup>52</sup> Sheppard, *supra* note 37, at 354.

<sup>53</sup> Ely, *supra* note 26, at 407.

<sup>54</sup> *Id.*

<sup>55</sup> See also, Arthur R. Rosen & Melissa A. Connell, *State Tax Nexus Issues – the Decades-Old Debate Continues in the Shadow of the Internet*, J. TAX’N, 303, 310 (2001).

<sup>56</sup> William R. Thomas, *Attributional Nexus: Waiting for the Levee to Break*, TAXES, 3, 3 (January 1995).

<sup>57</sup> Elisa Fay & Sharlene Amitay, *Attention LLC Members: Is Nexus a Foregone Conclusion?*, TAX NOTES, Oct. 1, 2001, at 145.



state treats SMLLCs as “disregarded entities” (similar to federal check-the-box regulations). After all, as a disregarded entity, SMLLC gains or losses are treated as the gains and losses of the owner of that SMLLC.<sup>58</sup> But within states that do not consider SMLLCs as disregarded entities, many question a state’s authority to tax out-of-state businesses and individuals whose sole connection with that state is investment ownership in an in-state business, especially if the state tax statute requires that taxpayers must be “doing business” or “owning property” within that state.<sup>59</sup>

Setting LLCs and SMLLCs aside for the moment, a fundamental issue remains unanswered: “whether a company with no presence other than owning another company that has a nexus can be subjected to a state’s corporate income tax.”<sup>60</sup> In June 2007, the Supreme Court denied review of two cases that challenged the constitutionality of state taxation of out-of-state companies that lack a physical presence, but maintain an ownership interest in an in-state company.<sup>61</sup> The Supreme Court has yet to explicitly articulate a clear nexus standard for states to adopt.

Within this constitutional murkiness the SMLLC has emerged. Neither a partnership nor a corporate subsidiary, the hybrid SMLLC is treated for federal income tax purposes as a disregarded entity (similar to a sole proprietorship). But states view SMLLCs differently, some following federal income tax treatment and considering a SMLLC as a disregarded entity, while others subject them to entity-level taxation. If states decide to treat SMLLCs as disregarded entities, then the single owner (resident or non-resident) would have nexus because the SMLLCs acts would be deemed the owner’s acts. However, if states decide to treat SMLLCs more like corporations by taxing them at the entity level, then whether states may subject the single non-resident owner of an in-state SMLLC will depend remain dependent on each state’s preference until the Supreme Court decides otherwise. With both issues unsettled, entrepreneurs looking to expand their businesses with SMLLCs in neighboring states should remain aware of the various possible taxation liabilities.

The Due Process Clause and the Commerce Clause of the Constitution limit a state’s power to tax out-of-state entities by requiring a nexus between the entity and the taxing state.<sup>62</sup> While the Supreme Court has yet to consider whether a state may subject a non-resident to state income tax based on its ownership interest in the in-state company satisfies

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<sup>58</sup> Ketema, *supra* note 1, at 1669.

<sup>59</sup> See Ely, *supra* note 26, at 407.

<sup>60</sup> Fox, *supra* note 34, at 31.

<sup>61</sup> FIA Card Servs. NA v. West Virginia Tax Comm’r, U.S., No. 06-1228, *cert. denied* 6/18/07; Lanco Inc. v. Dir., New Jersey Div. of Taxation, U.S. No. 06-1236, *cert. denied* 6/18/07; *Supreme Court Declines to Review Challenges To State Taxes on Out-of-State Companies*, DAILY TAX REPORT, No. 117, June 19, 2007

<sup>62</sup> Fay & Amitay, *supra* note 57, at 145.

both the Commerce and Due Process Clauses,<sup>63</sup> case law provides useful guidance for general taxation purposes.

A. *Due Process Clause Requires "Minimum Contact" Between the Taxpayer and the Taxing State*

In order to satisfy the Due Process Clause, the Supreme Court requires a minimum level of contacts between a taxing jurisdiction and the enterprise being taxed.<sup>64</sup> In *Wisconsin v. J.C. Penney*, the Court held that "[t]he simple but controlling question is whether the state has given anything for which it can ask return."<sup>65</sup> Applying this standard, the Court held that a Wisconsin corporate income tax on earnings attributable to Wisconsin satisfied the Due Process Clause.<sup>66</sup> Requiring a state to prove a minimal connection with activities taxed protects the purpose of the Due Process Clause: to require government to deal fairly with its citizens. After all, "nothing could be fairer than to force a state to have some connection or nexus with the activity that is being taxed."<sup>67</sup>

By only requiring a "minimum connection" between the activity taxed and the taxing state, the Supreme Court interpreted the Due Process Clause to create a standard for a state's tax jurisdiction similar to that of the minimum contacts standard for *in personam* jurisdiction purposes depicted *International Shoe Co. v. State of Washington* and later its progeny *Burger King Corp. v. Rudzewicz*.<sup>68</sup> Using this standard, "a state's taxing jurisdiction extends to any business that purposefully directs its economic activities into the state."<sup>69</sup>

As a result, the ability of a state to tax an LLC *member* without violating the Due Process Clause could turn on "whether the state has personal jurisdiction over the LLC member."<sup>70</sup> Such an inquiry may depend on the relationship between the LLC and its member. In a situation where a non-resident LLC member does not manage the in-state LLC, while jurisdiction should attach to the LLC with in-state activities, "due process considerations could preclude the assertion of jurisdiction over a non-managing LLC member."<sup>71</sup>

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<sup>63</sup> *Id.*

<sup>64</sup> Walter Nagel, *The Emergence of a Single Nexus Standard*, TAX NOTES, Oct. 16, 1989 at 327-328; see also *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435 (1940).

<sup>65</sup> *J.C. Penney Co.* 311 U.S. at 445.

<sup>66</sup> *Id.* at 442.

<sup>67</sup> Nagel, *supra* note 64, at 330.

<sup>68</sup> *Quill Corp. v. North Dakota*, 504 U.S. 298, 307 (1992), citing *Burger King Corp. v. Rudzewicz*, 471 U.S. 462 (1985).

<sup>69</sup> Rosen & Connell, *supra* note 55, at 304.

<sup>70</sup> Fay & Amitay, *supra* note 57, at 146.

<sup>71</sup> *Id.*

B. *Commerce Clause Requires “Substantial Contact” Between the Taxpayer and the Taxing State*

In contrast, for state taxation to survive a Commerce Clause challenge, the Supreme Court requires a state to prove a higher nexus standard: that the “activity being taxed have ‘substantial nexus’ with the state seeking to impose the tax.”<sup>72</sup> In *Complete Auto Transit, Inc. v. Brady*, the Court considered the legality of Mississippi imposing a sales tax on the activities of a Michigan corporation within Mississippi premised on the “privilege of doing business” within the state.<sup>73</sup> The question of interstate commerce arose because General Motors vehicles were assembled outside of the state, shipped to Jackson, Mississippi by rail, where the appellant corporation picked them up and transported them to Mississippi dealers.<sup>74</sup> The appellant corporation argued that because its shipping activities were “part of interstate commerce,” taxing them for the “privilege of doing business” within Mississippi violated the Commerce Clause.<sup>75</sup>

While the Supreme Court ultimately concluded that the Mississippi sales tax was constitutional, it established a four-pronged test to determine constitutionality of a state tax under the Commerce Clause. Under the four-pronged test, a state tax will survive a Commerce Clause challenge if the “tax [1] is applied to an activity with a substantial nexus with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the state.”<sup>76</sup> The Court reasoned that if a state tax failed to meet these four criteria, the tax would unconstitutionally infringe on interstate commerce.

In essence, the Commerce Clause’s “substantial nexus” requirement established in *Complete Auto Transit* creates a higher barrier for states to tax non-resident owners of in-state businesses than the “minimum contacts” test under the Due Process Clause. This higher standard reflects the main purpose of the Constitution authorizing Congress to regulate commerce among the states: “to put an end to the onerous and vexatious taxes and duties with which [commerce] had been burdened by state legislation.”<sup>77</sup>

Yet uncertainty remained as to whether *Complete Auto Transit* implicitly overruled the 1967 Supreme Court case that held that a non-resident business or individual must have physical presence within a state to be subject to that state’s taxes.<sup>78</sup> In *Bellas Hess*, the Supreme Court invalidated an Illinois use tax on out-of-state mail order businesses on mail

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<sup>72</sup> *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

<sup>73</sup> *Id.* at 274.

<sup>74</sup> *Id.* at 276.

<sup>75</sup> *Id.* at 278.

<sup>76</sup> *Id.* at 279.

<sup>77</sup> *Case of State Freight Tax*, 82 U.S. 232, 1872 U.S. LEXIS 1252 at \*\*\*16 (1872).

<sup>78</sup> *Nat’l Bellas Hess, Inc. v. Dep’t of Revenue of Illinois*, 386 U.S. 753 (1967).

order sales made to state residents.<sup>79</sup> The Court in *Nat'l Bellas Hess Inc. v. Dep't of Revenue of Illinois* reasoned that by taxing a business with no physical presence in the state would create "unjustifiable local entanglements" thereby hindering interstate commerce.<sup>80</sup> It wasn't until fifteen years later that the Supreme Court explicitly addressed the issue.

C. *The Crux of the Debate: Does Quill Govern Income Tax?*

Fifteen years after *Complete Auto Transit*, the Supreme Court reaffirmed its four-pronged test and harmonized it with *Bellas Hess*'s presence rule to determine constitutionality of state taxes.<sup>81</sup> In *Quill Corp. v. North Dakota*, North Dakota imposed a use tax withholding obligation on every retailer maintaining a place of business within the state.<sup>82</sup> A mail-order house incorporated in Delaware with no offices, warehouses, or employees in North Dakota refused to withhold the use tax, arguing that the tax violated the Due Process and Commerce clauses of the Constitution.<sup>83</sup>

To determine the constitutionality of the North Dakota tax, the *Quill* Court applied both the Due Process "minimum connection" test and the Commerce Clause "substantial nexus" test, concluding that for a state tax to be constitutional, it must satisfy both standards.<sup>84</sup> The Court held that the Due Process Clause did not bar the use tax because the mail-order house purposefully directed activities at North Dakota residents, benefited from such activities, and the use tax was related to these benefits the mail-order house received from access to the state.<sup>85</sup>

The *Quill* Court not only reaffirmed the four-pronged test established in *Complete Auto Transit*, but harmonized it with the *Bellas Hess* by describing a taxpayer's physical presence as a requirement for satisfying the "substantial nexus" test.<sup>86</sup> In doing so, the *Quill* court embraced the bright-line physical presence rule, "at least for sales and use tax purposes."<sup>87</sup> Acknowledging that the law surrounding state taxation of non-resident individuals and businesses is "something of a 'quagmire,'" leaving "much room for controversy and confusion and little in the way of precise guides to the States" in their power of taxation, the *Quill* Court adopted a bright-line test to minimize ambiguity and encourage

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<sup>79</sup> *Id.* at 760.

<sup>80</sup> *Id.*

<sup>81</sup> *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

<sup>82</sup> *Id.* at 302.

<sup>83</sup> *Id.* at 302-303.

<sup>84</sup> Rosen & Connell, *supra* note 55, at 304.

<sup>85</sup> *Quill Corp.*, 504 U.S. at 308.

<sup>86</sup> *Id.* at 318.

<sup>87</sup> Fay & Amitay, *supra* note 57, at 148; *see also Quill Corp.*, 504 U.S. at 317.

predictability.<sup>88</sup> Stability, the Court hoped, would foster investment and growth in interstate commerce.<sup>89</sup>

But the *Quill* Court did not extend the physical presence rule to state income taxation. Nor did it expressly limit its bright-line rule to only sales and use taxation. Instead, the *Quill* court stated: “although in our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar bright-line, physical-presence requirement, our reasoning in those cases does not compel that we now reject the rule that *Bellas Hess* established in the area of sales and use taxes.”<sup>90</sup> Thus, the question whether *Quill*’s physical presence test extends or should extend to apply to state income tax regulations remains unanswered.<sup>91</sup> If the physical presence rule applies to income tax, non-resident individuals or businesses whose only contact with a state is an ownership interest in an in-state business entity will not be held liable for that state’s income tax. If, however, the presence test is limited to use and sales tax, such non-resident individuals and companies could be liable for income taxes in every state where they have an ownership interest in a company.

Since *Quill*, several state courts have concluded that *Quill* does not preclude them from withholding income tax on an out-of-state individual and company whose only contact with the state is an ownership interest in an in-state entity.<sup>92</sup> In doing so, state courts reason that use and sales taxes require *Quill*’s physical-presence rule while income taxes do not because sales and use taxes impose more onerous compliance demands than do income taxes.<sup>93</sup> The North Carolina Court of Appeals justified such a conclusion by comparing compliance requirements: “state income tax is usually paid only once a year, to one taxing jurisdiction and at one rate, [but] a sales and use tax can be due periodically to more than one taxing jurisdiction within a state and at varying rates.”<sup>94</sup>

In contrast, businesses argue that *Quill* should apply to state income taxation as well. To limit *Quill* to use and sales tax, businesses predict, will create a “climate of uncertainty and potential harshness” that will severely burden entrepreneurs in interstate commerce.<sup>95</sup> First, “the complexities and compliance demands of income tax laws require greater certainty and a

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<sup>88</sup> *Quill Corp.*, 504 U.S. at 315.

<sup>89</sup> *Id.* at 316.

<sup>90</sup> *Id.* at 317.

<sup>91</sup> See *Fay & Amitay*, *supra* note 57, at 148, n.36. While the *Quill* Court “did not explicitly limit the application of the Commerce Clause physical presence requirement to sales and use taxes... several state tribunals have concluded that *Quill* applies to income taxes.” *Id.*

<sup>92</sup> Brief for Sherwin-Williams Co. as Amicus Curiae Supporting Petitioner at 2; *Lanco, Inc. v. Director, Div. of Taxation*, No. 06-1236 (U.S. May 14, 2007), *cert. denied*, 127 S.Ct. 2974 (2007).

<sup>93</sup> See *id.* at 6.

<sup>94</sup> *Id.*, quoting *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 194 (N.C. App. 2004).

<sup>95</sup> *Id.* at 3.

clearer nexus rule than sales and use tax law demands.”<sup>96</sup> Businesses reason that income, more than other taxes, subject taxpayers to complex compliance demands. For example, many states impose their own income taxes on corporations and some require multiple income tax filings each year.<sup>97</sup> Additionally, jurisdictions vary greatly in their income tax rates, timing of payments, requirements for reporting (some require combined reporting, while others permit each entity to file a separate return), deductions, and credits.<sup>98</sup> “The amount of time and resources spent researching and collecting data necessary to claim certain state and local [income tax] deductions and credits alone can be staggering.”<sup>99</sup>

Second, state income tax negatively impacts a company’s financial reputation, requiring the physical presence rule to apply to income tax in order to provide more certain notice to multi-state companies. While sales and use tax is withheld by reducing funds businesses collect from customers, income tax is deducted from a company’s overall earnings.<sup>100</sup> Because shareholders and other investors “generally gauge a corporation’s health by how much that corporation earns per share,” state income tax withheld can have more direct negative impact on a corporation than use and sales tax.<sup>101</sup>

Third, if *Quill* is limited to use and sales tax, businesses fear that they “may be liable for unquantifiable back taxes and interest attributable to long ago tax years.”<sup>102</sup> For example, before State A held that *Quill*’s physical-presence test did not determine state income tax nexus, an individual without physical presence in State A who owned a company formed under State A law and located within State A, may have reasonably relied on *Quill* and found no reason to file an income tax return in State A. However, because, in most jurisdictions, the statute of limitations commences when a business does not file a return,<sup>103</sup> State A, after denying *Quill* applicability, may hold an out-of-state business liable for state income tax, penalties for failure to file a return, and exorbitant back taxes.

Some state courts explicitly or implicitly hold that *Quill*’s bright-line physical presence test should not determine state income tax nexus.<sup>104</sup>

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<sup>96</sup> *Id.*

<sup>97</sup> *Id.* at 7.

<sup>98</sup> Amicus Brief for Sherwin-Williams Co. at 8.

<sup>99</sup> *Id.*

<sup>100</sup> *Id.* at 10.

<sup>101</sup> *Id.* at 11.

<sup>102</sup> *Id.* at 12.

<sup>103</sup> *Id.* at 12.

<sup>104</sup> For example, see *Geoffrey, Inc. v. S.C. Tax Comm’n*, 313 S.C. 15, 23 (S.C. 1993) (rejecting petitioner’s contention that South Carolina cannot impose income tax on his royalty because he is not physically present in South Carolina); *Couchot v. State Lottery Comm’n*, 659 N.E.2d 1225, 1230 (Ohio, 1996) (holding that nonresident individual without physical presence in Ohio is subject to income tax on Ohio lottery winnings).

Businesses rebut that if *Quill*'s physical presence test does not determine nexus for state income tax purposes, uncertainty will prevent multi-state businesses from confidently expanding their interstate activities.<sup>105</sup> Until the Supreme Court issues an opinion settling the debate, entrepreneurs looking to expand to other states under any entity should fully research potential future state income tax liabilities.

#### V. UNCERTAINTY SURROUNDING SMLLCs: POTENTIAL STATE INCOME TAX OVERLAP IN OHIO

With the scope of *Quill* unresolved, a number of states have continued to claim state income tax nexus with out-of-state owners of in-state SMLLCs or established entity-level taxation of entities considered disregarded for federal income tax purposes. Dissimilarities in state income tax nexus approaches and entity-level taxation have led to even further uncertainty as to how states can or will tax non-resident individuals or businesses whose sole contact with the state is an ownership interest in an SMLLC.

Ohio, for example, in 2001 issued an income tax information release to clarify Ohio tax nexus standards for determining (1) when a non-resident is subject to Ohio's personal income tax and (2) when a pass-through entity has a nexus with Ohio and is therefore subject to the pass-through entity tax. Ohio taxes out-of-state corporations and out-of-state individuals when they have nexus with Ohio under the U.S. Constitution.<sup>106</sup> The Ohio Department of Taxation ("ODT") created a list of activities that establish tax nexus with Ohio. A corporation, pass-through entity (LLC, for example) or an individual is considered to have substantial nexus with Ohio by "having a direct or indirect ownership interest in a pass-through entity having nexus with this state."<sup>107</sup> Ohio therefore claims Ohio income tax nexus over non-resident individuals and companies by interpreting *Quill*'s presence rule to limit only a state's ability to impose sales and use tax.

With some states expanding their income tax nexus now holding non-residents liable for income tax, and others expanding their tax base to tax pass-through entities directly, some taxpayers have become liable in multiple states for taxes on what is, arguably, the same income. In general,

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<sup>105</sup> *Id.* at 3.

<sup>106</sup> Information Release, Ohio Dept. of Taxation, Pass-Through Entity Tax Nexus Standards, (Sept. 2001), *available at* [http://tax.ohio.gov/divisions/communications/information\\_releases/documents/Nexus%20--%20PET%20--%20Final.doc](http://tax.ohio.gov/divisions/communications/information_releases/documents/Nexus%20--%20PET%20--%20Final.doc) (last visited Sept. 22, 2008); Information release, Ohio Dept. of Taxation, Personal Income Tax Nexus Standards, (Sept. 2001), *available at* [http://tax.ohio.gov/divisions/communications/information\\_releases/documents/Nexus%20--%20PIT%20--%20Final.doc](http://tax.ohio.gov/divisions/communications/information_releases/documents/Nexus%20--%20PIT%20--%20Final.doc) (last visited Sept. 22, 2008).

<sup>107</sup> Pass-Through Entity Tax Nexus Standards, *supra* note 106 at 5; Personal Income Tax Nexus Standards, *supra* note 105 at 5.

a state may tax a nonresident's income that is either (1) earned in the state or (2) earned from in-state sources.<sup>108</sup> Additionally, the state in which an individual resides may tax all income earned by that resident.<sup>109</sup> To avoid double taxation, "resident states generally allow an income tax credit for income subject to tax in another jurisdiction, if certain criteria are met."<sup>110</sup>

A 2006 information release from the ODT illustrates a state's refusal to offer a tax credit for taxes paid to another state. The ODT release specified that an Ohio resident individual who owns a Kentucky pass-through or disregarded entity subject to the Kentucky corporation income tax cannot claim an Ohio resident tax credit.<sup>111</sup> In 2005, Kentucky expanded its tax base to include a tax on pass-through entities (LLCs, SMLLCs, etc.).<sup>112</sup> Kentucky viewed its corporation income tax on pass-through entities as a tax on the entity, and not on the investor's income. However, in Ohio, "equity investors in pass-through entities can choose to have their pass-through entities pay the Ohio income tax due by the equity investors, but each investor remains personally liable for his/her unpaid Ohio individual income tax."<sup>113</sup> In other words, Kentucky tax is imposed on income that is considered the investor's income under Ohio law.

Yet despite this difference in taxation between Ohio and Kentucky in 2006, the ODT stated that the Ohio tax credit is not available to an Ohio resident owning a Kentucky LLC even if that Ohio resident elects to pay the Kentucky tax on behalf of the LLC.<sup>114</sup> As a result, an Ohio resident's ownership interest in an LLC will actually be subjected to a double taxation similar to a corporation, thereby eliminating a main attraction of the LLC entity: single taxation.

An example will illustrate the potential state tax overlap between Ohio and Kentucky income tax regulations. Assume an Ohio resident, Owen, wholly owns a single-member LLC organized under Kentucky law. Kentucky imposes an entity-level tax of 10% on pass-through entities, including SMLLCs, and Ohio imposes a 10% tax on income earned by its residents. The Kentucky SMLLC pre-tax income equals \$1000 in a given

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<sup>108</sup> Rood & Nakamura, *supra* note 48, at 361.

<sup>109</sup> *Id.*

<sup>110</sup> *Id.* "In general, states look to an individual's physical location in determining whether income is earned in the state." *Id.*

<sup>111</sup> Information Release, Ohio Dept. of Taxation, Inapplicability of Ohio Resident Credit with Kentucky Corporate Income Tax (Mar. 2006), available at [http://tax.ohio.gov/divisions/communications/information\\_releases/index.stm#IncomeTax](http://tax.ohio.gov/divisions/communications/information_releases/index.stm#IncomeTax) (last visited Sept. 22, 2008).

<sup>112</sup> *Id.*; See also Kentucky H.B. 1, *supra* note 40. In 2007, Kentucky repealed its application of the Kentucky Corporation Income Tax to limited liability entities and created a separate limited liability entity tax. The ODT has yet to release whether a tax credit will similarly not be available for an Ohio resident who owns a Kentucky SMLLC subjected to the new limited liability tax.

<sup>113</sup> *Id.*

<sup>114</sup> *Id.*



year, making the SMLLC liable for a \$100 Kentucky entity-level tax. Kentucky in turn permits Owen a credit against his proportionate share of the SMLLCs income, therefore not holding him liable for personal income tax. As a result, Kentucky does not expose Owen to double taxation and Owen's tax liability to Kentucky totals \$100. The remaining \$900 of the Kentucky SMLLC's \$1000 pre-tax earnings becomes part of Owen's adjusted gross income that he would then have to report for Ohio personal income tax purposes. Under ODT's 2006 information release, Owen cannot receive credit for the paying the Kentucky entity-level tax. Therefore, Ohio would hold Owen liable for 10% of his full \$1000 pre-tax income earned from his Kentucky SMLLC. By the end of the year, on his \$1000 earning from his ownership interest in a Kentucky SMLLC, Owen would be liable for a total of \$200 between Kentucky entity-level taxation and Ohio's income tax regulations. As a result, Owen is exposed to a double taxation (entity-level in Kentucky, personal in Ohio) to which he would not be liable if he were a resident of Kentucky.<sup>115</sup>

## VI. OPTIONS FOR ENTREPRENEURS

So what options remain for entrepreneurs seeking to navigate safely through these state income tax regulation disparities? First, entrepreneurs should fully research the income tax regulations surrounding their state of residency and the state to which they are seeking to expand. An entrepreneur should be especially wary if disparities in state income tax treatment exist between his or her residency state, and the state targeted for expansion.<sup>116</sup>

Second, to avoid uncertainty surrounding SMLLC tax treatment an entrepreneur that wholly owns a SMLLC can incorporate, creating a parent-subsidary corporate entity instead of a limited liability company. Ideally, an S corporation would serve best by offering limited liability while maintaining a pass-through nature in many states. But S corporations may subject the entrepreneur to further restrictions if they hope to one day expand further.<sup>117</sup> But keep in mind that until *Quill's* physical-presence

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<sup>115</sup> See Kentucky H.B. 1, *supra* note 40. Again, in 2007 Kentucky repealed its expansive definition of "corporation" under its corporation income tax and instead adopted a separate limited liability entity tax, which implicitly removed this potential tax overlap. But the Kentucky-Ohio example above illustrates the possible liability for other individuals or businesses who own SMLLCs in multiple states so long as state income tax treatment of SMLLCs remains so dissimilar.

<sup>116</sup> Further information regarding multi-state taxpayers reporting requirements according to the Multistate Tax Commission's National Nexus Program are available at <http://www.mtc.gov/Nexus.aspx?id=526> (last visited Sept. 22, 2008).

<sup>117</sup> See I.R.C. §1361, *supra* note 17. While an S corporation is treated as a pass-through entity subject to a single level of taxation, an S corporation cannot contain more than 100 shareholders and must only offer one class of stock. Additionally, a concerned entrepreneur considering incorporation under S corporation form will need to undergo

rule is either explicitly extended to state income tax or limited to use and sales tax, an entrepreneur should understand that if their corporate subsidiary conducts business in a state that argues for *Quill*'s limited scope, that non-resident entrepreneur may still be liable for the state's income tax.

Finally, concerned entrepreneurs may lobby to state tax administrations and ask them to cooperate with other states to create a uniform state income tax arrangement. In particular, entrepreneurs may contact the National Tax Association to push for an agenda to establish uniformity in state tax treatment of SMLLCs. The National Tax Association has recently introduced a multijurisdictional uniform sales and use tax certificate that has been accepted by the majority of states<sup>118</sup> Uniform state income tax treatment of SMLLCs will certainly not occur overnight, but the National Tax Association's achievement for sales and use tax can offer some hope to concerned entrepreneurs.

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more extensive paperwork than the typical LLC or SMLLC. But if an entrepreneur's main concern is to assure his business will not be subjected to a double-taxation that may be possible under interstate SMLLCs, an S incorporation may seem a very attractive option.

<sup>118</sup> Uniform Sales and Use Tax Certificate – Multijurisdiction, *available at* <http://www.synnex.com/forms/taxcert.pdf> (last visited June 15, 2008).